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ABSTRACT

Data from the Current Population Survey of 1971 are used in this paper to investigate the ways in which various population groups utilize their earnings capacity. The hypotheses tested in this paper are: (1) that groups are poor primarily because they fail to utilize their earnings potential effectively; and (2) that the high incidence of poverty among blacks is attributable to their failure to take advantage of earnings opportunities. Comparisons are made between earnings capacity and rates of capacity utilization for individuals and family units along the dimensions of marital status, sex and race. Findings indicate that the relationship between utilization and potential earnings is greater for nonmarried individuals than for married units, greater for married males than for married females, and that differences in utilization and potential earnings between blacks and whites along all dimensions is relatively small. It is concluded that low utilization of earnings potential plays a minor role in explaining the poverty problem and that racial differences in earnings cannot be attributed to racial differences in capacity utilization. (Author/EB)

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EARNINGS CAPACITY AND ITS UTILIZATION

Irwin Garfinkel and Robert Haveman, with the assistance of David Betson

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EARNINGS CAPACITY AND ITS UTILIZATION*

IRWIN GARFINKEL AND ROBERT HAVEMAN,
WITH THE ASSISTANCE OF DAVID BETSON

The relationship of actual earnings to full-time earnings potential (which we shall term earnings capacity) for various demographic groups is both of intrinsic interest and of relevance to discussions of social policy. For example, extension of transfer benefits to certain low-income groups (such as nondisabled, non-aged intact families) has been opposed on grounds that these groups are poor primarily because they fail to utilize their earnings potential effectively. Similarly, the high incidence of poverty among blacks is regarded by some as evidence of a failure to take advantage of earnings opportunities.

In this paper we investigate patterns of earnings capacity utilization among various population groups. To do this, we define and measure the earnings capacity of individuals and family units, and then observe how the ratio of observed earnings to earnings capacity varies among population groups. Section I presents the definitions and procedures employed to measure the relationship of earnings to earnings capacity. Section II describes the estimated utilization patterns among population groups. Section III presents a summary of these patterns and their implications.

I

The earnings capacity of an individual or a family unit is defined as the net income flow generated by the unit if its human capital endowment is used at its full potential. This potential earnings indicator of economic status is designed to abstract from the unit's tastes for, and transitory fluctuations in, income.

Our data source is the *Current Population Survey of 1971*, aged to represent the structure of the population and economy in 1973.[1] The specific measure of earnings capacity is the predicted annual earnings of an individual if he or she worked full-time and full-year (50–52 weeks). It is estimated for each family head and spouse from the log-linear earnings equations shown in Table I, in which annual earned income is the dependent variable and the individual's human capital and demographic characteristics (age, years of schooling, race,

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TABLE I

EARNINGS FUNCTIONS FOR BLACK AND WHITE AND MALES AND FEMALES

Independent variables	Males		Females	
	White coefficient (t-value)	Black coefficient (t-value)	White coefficient (t-value)	Black coefficient (t-value)
Years of schooling	0.0212 (3.0)	−0.0088 (−0.4)	−0.0106 (−0.7)	−0.0229 (−0.7)
Years of schooling^2	0.0007 (3.2)	0.0017 (2.8)	0.0033 (6.5)	0.0047 (4.3)
Age	0.0711 (33.3)	0.0525 (7.1)	0.0479 (13.3)	0.0234 (2.2)
Age^2	−0.0008 (−42.6)	−0.0007 (−10.0)	−0.0006 (−18.1)	−0.0004 (−4.0)
Age × years of schooling	0.0005 (5.6)	0.0004 (1.5)	0.0001 (0.5)	0.0004 (0.8)
Weeks worked 1–13	−1.9636 (−85.8)	−2.0173 (−31.1)	−2.2937 (−111.8)	−2.0924 (−39.4)
14–26	−0.8201 (−44.2)	−0.8324 (−17.1)	−0.9790 (−48.0)	−0.8835 (−16.4)
27–39	−0.4103 (−27.2)	−0.3742 (−8.5)	−0.4851 (−22.6)	−0.4215 (−7.8)
40–47	−0.2067 (−13.9)	−0.2563 (−5.9)	−0.2395 (−9.8)	−0.2097 (−1.4)
48–49	−0.1434 (−7.1)	−0.0970 (−1.6)	−0.1446 (−4.0)	−0.0124 (−0.1)
50–52	—	—	—	—

Full- or part-time work during week				
Full-time	——	——	——	——
Part-time	−0.9105 (−51.0)	−0.9827 (−21.2)	−0.9162 (−61.3)	−0.8767 (−22.4)
Location				
Northeast	−0.0149 (−1.6)	−0.0197 (−0.5)	0.1292 (7.5)	0.1154 (2.2)
North central	——	——	——	——
South	−0.1120 (−12.2)	−0.2362 (−7.5)	−0.416 (−2.5)	−0.2017 (−4.4)
West	−0.0541 (−5.3)	0.0132 (0.3)	−0.0299 (1.6)	−0.0316 (−0.5)
SMSA suburb	0.1542 (18.7)	0.2664 (7.1)	0.1790 (11.7)	0.2647 (4.9)
SMSA central city	0.0685 (8.0)	0.1609 (5.7)	0.1885 (12.2)	0.2133 (5.2)
Nonurban	——	——	——	——
Marital status				
Not married—no children			0.1243 (6.1)	−0.0113 (−0.2)
Not married—with children			0.0524 (2.1)	−0.0378 (−0.9)
Married—no children			0.1261 (7.8)	−0.0030 (−0.1)
Constant	7.2901 (96.8)	7.6699 (32.5)	7.1515 (49.0)	7.5754 (20.3)
R^2	0.5252	0.6068	0.6026	0.6337
F	1,813.7819	266.8581	1,498.4130	247.2347

Note: The dependent variable is the natural logarithm of annual earnings, in dollars.

marital status, location, and work time) serve as independent variables.[2] The R^2's for the regressions range from 0.52 for white males to 0.63 for black females. The estimated coefficients are as expected.

The imputed earnings potential estimates are aggregated into estimates of family earnings capacity by summing the imputed value for the head with that of the spouse (if a spouse is present) for those units identified in the data files. However, prior to aggregation, the imputed values of individuals reporting weeks of nonwork for reasons of sickness, disability, or unemployment (W_{su}) are multiplied by the fraction $50 - W_{su}/50$ in order to account for exogenous limitations on economic capacity due to either health disabilities or insufficient aggregate demand.

Although this adjustment builds some temporary income fluctuations into the imputed value for an individual or a family, there is a strong argument for it.[3] To the extent that the magnitude of involuntary loss of work due to illness and unemployment is related to earnings potential, failure to adjust for these limitations would bias estimates of the relationship of capacity utilization to potential or capacity earnings.[4]

Before analyzing our empirical results, the nature of our measure of earnings capacity should be stressed.[5] Consider two full-time, full-year workers of identical age, sex, race, years of schooling, and location who have actual earnings of $10,000 and $5,000. The mean earnings capacity for their cell is $7,500. This value is imputed to each individual. The implication is that the gap between actual and potential earnings is due to differences in taste or to transitory effects. However, it is possible that the difference in earnings between the two individuals is due entirely to the systematic and persistent effects of unobserved variables. One individual may be handsome, the other plain. One may be strong, the other weak. One may be bright, the other dull. Similarly, the earnings difference could be attributable to differences in the quality of education or the demand for labor services. Finally, the difference may be due to chance. Our data capture none of these effects. We explicitly note particular cases where the effects of unmeasured differences may be significant. Moreover, we argue that our major conclusions would be reinforced if measures of these differences were available.

II

Substantial variation in the utilization of earnings potential—defined as the ratio of observed to potential earnings (UR)—is likely

to exist among subgroups of the population. Because the *UR* of an individual is positively related to his or her work effort, factors that account for variation in individual work effort will also contribute to the variation in *UR*. These factors include (1) income, (2) the rewards for and costs of working, (3) tastes for income versus leisure, and (4) the availability of work. For example, because of child care costs, women with children will tend to have a lower average *UR* than women without children. Similarly, because of differences in current and previous social expectations regarding labor force participation of men and women, men will tend to have higher average *UR* than women. In addition, because income transfer programs simultaneously increase the incomes of beneficiaries and reduce the rewards to them from working, individuals eligible for such programs—for example, female heads of households—will tend to work less, ceteris paribus, than ineligible individuals. In contrast to these predictions, expectations regarding the relationship of *UR* to the level of capacity earnings are not so clear. On the one hand, those with high earnings potential may tend to work less because they have more income; on the other hand, they will tend to work more because the reward for working is higher.

There are, of course, sources of variation in *UR* other than hours worked. These include such factors as occupational choices and compensating variations in wage rates. Nevertheless, because of the sizeable contribution of voluntary variations in hours worked to the explained variance in the regressions, this variable would appear to be the major source of differences in *UR* among population groups. Because the capacity utilization measure both permits aggregation over individuals in a family unit and enables capacity utilization to be naturally related to the level of capacity, its use is preferred to some measure of hours worked.

Table II presents two sets of *UR* estimates for several subgroups of the non-aged population. In the top part of the table, the observed mean *UR* is shown for groups distinguished by race, sex, and marital status. Several interesting patterns should be noted. For example, the average white unit has a slightly higher *UR* than the average black unit—0.61 compared to 0.58. This pattern holds for all males, whether married or single. However, the average black female tends to have a substantially higher *UR* than the average white female—0.43 compared to 0.31. This result is largely accounted for by black wives who have a substantially larger labor force participation rate than white wives.

Also, single males have a much lower observed *UR* than married

TABLE II

OBSERVED AND ADJUSTED CAPACITY UTILIZATION RATES FOR THE NON-AGED POPULATION, BY SEX, MARITAL STATUS, AND RACE

	All	White	Black
Observed Utilization Rates (*UR*)			
All families and individuals	0.61	0.61	0.58
All males	0.85	0.86	0.80
Married males	0.88	0.89	0.84
Single males	0.66	0.66	0.65
All females	0.32	0.31	0.43
Married females	0.28	0.27	0.42
Female heads	0.42	0.42	0.41
Single females	0.55	0.55	0.52
Adjusted Utilization Rates (*AUR*)[a]			
All families and individuals	0.65	0.64	0.70
All males	0.84	0.84	0.84
Married males	0.87	0.88	0.86
Single males	0.68	0.68	0.74
All females	0.33	0.33	0.42
Married females	0.33	0.33	0.39
Female heads	0.46	0.45	0.52
Single females	0.64	0.64	0.70

a. See text and notes 6 and 7.

males for both racial groups. While some (perhaps all) of this difference can be attributed to differences between these two groups in tastes and in social and financial pressures to work, a portion of the difference may be due to an overestimation of the earnings capacity of single males relative to married males. Physical and mental disabilities not captured by our data may simultaneously reduce both true earnings capacity and the probability of getting married. Finally, it should be noted that single females utilize less of their capacity than do single males, but more than do married females and female heads of households.

These observed *UR* estimates, it should be noted, may be misleading as indicators of the relationship of race, sex, or marital status to the utilization of earnings capacity. For example, if married males on average have higher potential earnings than single males, and if *UR* is positively associated with potential earnings, a part of the married-single male *UR* differential will be due to the difference in potential earnings rather than to marital status.

This problem can be avoided by comparing the *UR* of various population groups, holding constant the level of potential earnings.

For example, rather than comparing the *UR* of the average black male with that of the average white male (as in the top part of Table II), we can compare the *UR* of the average black male having an earnings capacity of $\$X$ with that of the average white male *having the same earnings capacity*. These "earnings capacity constant" *UR* estimates, obtained by statistically holding potential earnings constant when comparing utilization among groups, are the second set shown in Table II, and are referred to as *adjusted UR* (*AUR*) estimates.[6]

In some cases the utilization patterns suggested by *AUR* differ from the observed ratios in the top part of the table. In particular, the racial comparison is reversed; *AUR* of non-aged black units (0.70) exceeds that of non-aged white units (0.64) when both are evaluated at the mean earnings capacity for the total non-aged population. Similarly, while black males have a lower *UR* than white males, *AUR* is equal for the two groups. Indeed, *AUR* is higher for single black males than for single white males—0.74 compared to 0.68.

The comparison of *UR* and *AUR* in Table II indicates a positive relationship between earnings capacity and rates of capacity utilization. In Table III this relationship is explored for the non-aged population stratified by marital status, sex, and race. The table presents estimates of utilization rates for each population group at each decile of the group's distribution of earnings capacity.[7]

As the second column indicates, within the total non-aged population *UR* increases steadily with potential earnings, from 0.56 at the first decile to 0.66 at the ninth. The relationship is stronger for blacks than for whites, but it is much less pronounced for the married population than it is for the total population—from 0.64 at the first decile to 0.67 at the ninth. Moreover, within the black married population the relationship is not monotonic; rather it is like an inverted U.

The overall patterns of family *UR* mask some interesting differences between male and female spouses. While *UR* is positively related to potential earnings for married males—from 0.84 at the first decile to 0.94 at the ninth—the pattern for married women is reversed. The *UR* of non-aged wives *decreases* uniformly as capacity increases from 0.35 at the first decile to 0.24 at the ninth. These patterns exist for both blacks and whites. Assuming that the earnings potentials of husbands and wives are positively related, the division of market work effort between husbands and wives appears to depend upon family earnings capacity. As one moves up the distribution of family earnings capacity, the differences in *UR* by husbands and wives offset one another, yielding the virtually flat relationship between *UR* and

TABLE III

UTILIZATION RATES OF THE NON-AGED POPULATION BY MARITAL STATUS, SEX, RACE, AND EARNINGS CAPACITY

Earnings capacity decile	Families & individuals			Married population			Men			Women		
	Total	White	Black	Total	White	Black	Total	White	Black	Total	White	Black
10	0.56	0.56	0.44	0.64	0.63	0.66	0.80	0.80	0.76	0.35	0.33	0.43
20	0.60	0.61	0.53	0.64	0.63	0.68	0.81	0.81	0.78	0.34	0.33	0.43
30	0.63	0.63	0.59	0.64	0.63	0.70	0.82	0.82	0.80	0.33	0.32	0.43
40	0.64	0.64	0.61	0.64	0.64	0.70	0.83	0.83	0.81	0.33	0.31	0.44
50	0.64	0.65	0.64	0.65	0.64	0.71	0.84	0.85	0.82	0.32	0.31	0.45
60	0.65	0.65	0.66	0.65	0.65	0.70	0.86	0.86	0.83	0.32	0.31	0.45
70	0.65	0.65	0.68	0.65	0.65	0.70	0.87	0.87	0.83	0.32	0.31	0.46
80	0.66	0.66	0.69	0.66	0.66	0.69	0.89	0.89	0.83	0.32	0.31	0.47
90	0.66	0.66	0.70	0.67	0.67	0.68	0.92	0.93	0.84	0.31	0.31	0.48

Earnings capacity decile	Married men			Single men			Married women			Single women		
	Total	White	Black	Total	White	Black	Total	White	Black	Total	White	Black
10	0.84	0.84	0.82	0.57	0.57	0.63	0.35	0.32	0.46	0.37	0.37	0.38
20	0.84	0.84	0.84	0.60	0.59	0.64	0.32	0.30	0.46	0.40	0.41	0.37
30	0.85	0.85	0.85	0.62	0.62	0.65	0.31	0.29	0.46	0.43	0.46	0.38
40	0.85	0.86	0.85	0.64	0.64	0.66	0.29	0.28	0.46	0.46	0.47	0.40
50	0.86	0.87	0.86	0.66	0.66	0.67	0.29	0.27	0.46	0.48	0.50	0.41
60	0.88	0.88	0.86	0.68	0.68	0.68	0.28	0.26	0.46	0.51	0.52	0.43
70	0.89	0.89	0.87	0.70	0.70	0.69	0.27	0.25	0.46	0.55	0.55	0.46
80	0.90	0.91	0.87	0.72	0.73	0.70	0.26	0.25	0.45	0.58	0.58	0.49
90	0.94	0.95	0.87	0.75	0.76	0.71	0.24	0.24	0.44	0.62	0.63	0.54

earnings capacity of non-aged families.

In contrast to this virtually flat relationship within the married population, the relationship of *UR* to capacity is positive and steep within both the male and the female nonmarried populations and, for both blacks and whites. For reasons suggested previously, this relationship may be somewhat exaggerated for the nonmarried population, and within this population the bias is likely to be greater for lower as opposed to higher capacity individuals.[8] In addition, this strong relationship may, in part, be due to differences in demand for high- and low-skilled workers. While our estimates of capacity are adjusted for reported weeks of unemployment, they are not adjusted either for the part-time work that results from this differential in demand or for the labor force withdrawals prompted by the unavailability of work.

Even if these possible biases were eliminated, however, this relationship between capacity and its utilization would, in all likelihood, remain. Among female heads of households, for example, welfare programs will tend to be more attractive to those with low earnings capacity than to those with high earnings capacity. Hence, female heads with low earnings capacity will be expected to substitute program income for earnings, implying a lower rate of capacity utilization. In general, the lower a person's earnings capacity, the less attractive from both monetary and nonmonetary standpoints is available employment.

III

In summary, then, the utilization of capacity increases steadily with the level of potential earnings among the non-aged population as a whole. Most of this increase is attributable to the relatively steep relationship between utilization and potential earnings within the nonmarried population. For married units, the relationship of utilization to capacity is virtually flat. The positive relationship between earnings potential and its utilization for married males tends to be offset by a negative relationship for married females.

Also, as indicated in Table II, the differences between the *UR* of blacks and whites are very small. Holding earnings potential constant, black families have a somewhat higher rate of utilization than white families. Racial differences in earnings, thus, cannot be attributed to racial differences in capacity utilization.

In general, low utilization of earnings potential plays a relatively minor role in explaining the poverty problem. The differences in

utilization rates between families of low and high economic status are swamped by differences in the potential earnings between these families. The ratio of the utilization rates of those at the first decile of all non-aged units to the utilization rates of those at the ninth decile is 0.87; the comparable ratio of earnings capacities is 0.27. This contrast is even clearer among the non-aged married population: While those at the lowest decile of potential earnings have virtually the same utilization rates as those at the top decile, those at the lowest decile have less than one-half the earnings capacity of those at the top decile.

This evidence provides no support for the hypothesis that the high poverty incidence among blacks and other population subgroups is primarily attributable to their failure to exploit economic potential. Indeed, estimates of capacity earnings based on functions with less unexplained variance would reinforce this conclusion. Unmeasured variables in our regressions, such as labor demand, are likely to reduce the relative capacity of individuals to whom we have already assigned a low capacity. For example, nonworkers are likely to have unmeasured characteristics that result in lower true potential earnings capacities than workers with identical measured characteristics, and nonworkers are more concentrated in the lower part of the earnings capacity distribution.

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NOTES

1. The 6 percent unemployment rate of 1970 was adjusted to 4.9 percent by randomly assigning unemployment and duration of unemployment experiences to groups identified by age, sex, occupation, and unemployment experience. See McClung, Moeller, and Siguel (1971).

2. The samples consist of only those with positive earnings. The inclusion of dummy variables for weeks worked and part- or full-time work during the weeks worked causes average overtime work to be included into the imputed value of earnings potential for each combination of values of the remaining variables. Comparisons between current income and earnings capacity measures of economic status were quite insensitive to the functional form used in estimating earnings capacity. Moreover, the log-linear model yields required nonnegative predicted earnings and reflects the likely positive relationship between the variance of earnings and the level of human capital. Finally, the log-linear model yields a somewhat better fit.

3. Data limitations preclude the distinguishing of permanent disabilities from temporary illnesses.

4. Part of the difference in weeks worked of unemployed or unhealthy individuals vis-à-vis those not affected by unemployment or ill health may be due to differences in tastes for work. This is likely to be minor, however. In any case, our adjustment tends to understate differences between the earnings capacity and current income measures that are taste dependent.

Three additional problems with the adjustment should be noted. First, some of the time that an individual is unemployed is attributable to the absence of a job that

the individual deems suitable. In this case we shall underestimate some individuals' potential earnings. Conversely, some individuals who cannot find jobs become discouraged and drop out of the labor force. We shall overestimate these individuals' earnings capacity. Finally, because the adjustment is made only for labor force participants, earnings capacity imputations for those not in the labor force will be somewhat overestimated.

5. It should also be noted that the designation of full-time, full-year work as capacity work effort is an arbitrary, though not unreasonable, choice. If all income were from earnings, the choice of the capacity norm would make little difference—everyone's wage would, in effect, be multiplied by the same constant.

6. The *AUR* estimates are obtained from the following regression:

$$E = a_0 + a_1EC + a_2EC^2 + a_3EC^3 + a_4St + a_5X,$$

where E is earnings, EC is adjusted capacity earnings, St is a binary variable indicating student status, and X is a dummy variable indicating the within-group comparison desired. Separate regressions were run for all subgroups indicated in the stub of Table II. In addition, separate regressions by race were run. Each regression was evaluated at the mean EC of the larger group to which its observations belonged (all families and individuals, all males, or all females). The resulting estimate of earnings was compared to the corresponding value of EC to obtain the *AUR* for the desired subgroups.

7. These estimates are obtained from the regressions of earnings on earnings capacity described in note 6. Each regression was evaluated at the deciles of the EC distribution for the major population groups and the resulting estimate of earnings at each decile was placed over the corresponding value of EC to obtain the capacity utilization rate at that decile.

8. A mentally retarded individual, for example, is more likely to be nonmarried. Moreover, because of low education he will have a low estimated earnings capacity. To be sure, most people with little or no education are not mentally retarded, and many have substantial earnings. But because our data do not distinguish among mental abilities within the group of those with low estimated potential earnings, true earnings potential will be below the estimated value.

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